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STATE FOR EAP/CM
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TREASURY FOR CUSHMAN
TREASURY FOR IMF/P SOBEL, MOGHTADER
NSC FOR WILDER AND LOI
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN

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SUBJECT: (SBU) ZHEJIANG SEEKING TO RESTRUCTURE AS ECONOMIC GROWTH DOWNTURNS

¶1. (SBU) Summary. Zhejiang Province is not likely to suffer a long-term economic downturn as a result of the global financial crisis, agree several Consulate contacts, but Zhejiang officials are seeking to use the current challenges to encourage firms to gradually restructure away from export dependence. Our interlocutors pointed to two causes of the economic deceleration: tight monetary policies and a slowdown in export growth as demand overseas fades. The worst conditions are likely to hit between the end of the year and June 2009, the interlocutors generally agreed. Businesses are asking workers to take salary freezes and cuts, and when faced with no choice are temporarily suspending production and sending workers home. End summary.

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Zhejiang Hoping Economic Crunch Will Pass . . .
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¶2. (SBU) A conviction that business conditions in Zhejiang Province will turn around by the middle of 2009 is driving economic decisionmaking in the province, we find, based on interviews with a variety of officials, scholars, and business leaders during November 19-20. Pan Guangen, director of the banking affairs department of the Zhejiang Provincial Government Financial Affairs Office, reflected a sentiment repeated at almost all meetings that the fourth quarter of this year through the first half of next year would be the hardest period. Most interlocutors also connected the eventual turnaround with the impact of the Central Government's putative RMB4 trillion economic stimulus program.

¶3. (SBU) Our interlocutors point to two factors in the economic downturn: 1) The government's crackdown on credit in the first half of 2007. Zhejiang Financial Affairs Office's Pan frankly criticized the People's Bank of China (PBOC) for maintaining a tight monetary policy for too long. Now "the plane has landed, and can't take off again," said Pan; banks are afraid to lend to small and medium-size enterprises (SMEs), and several large

enterprises have been hit with liquidity problems. Zhou Dewen, President of the Wenzhou SME Development and Promotion Association, also said that the government's macroeconomic controls were responsible for the deceleration in Wenzhou's economic growth in the first half. 2) The global financial crisis, and the accompanying downturn in import demand by China's trade partners. PBOC Hangzhou Subbranch President Zhou Yeliang said that "there has been a large impact from the financial crisis on Zhejiang, especially in light of the province's export dependence." Wenzhou SME Association's Zhou said that, following June, there has been a direct impact from the global crisis on exports.

¶4. (SBU) Several of our interlocutors expressed confidence that Zhejiang's SME exporters could quickly refocus on the domestic market. Zhejiang's companies are more nimble than Guangdong's, said Gao Jianming, vice president of the Zhejiang Provincial SME Bureau, because they are predominantly Chinese owned, while many of Guangdong's are joint ventures dependent on the foreign partner for marketing and distribution. PBOC's Zhou said that Zhejiang's manufacturers focus on everyday use products, which have great growth potential among domestic consumers. In addition, private enterprises dominate in Zhejiang, said PBOC's Zhou, making them more competitive under tough market conditions.

===== . . . While Indicators Show Difficulties Mounting =====

¶5. (SBU) Most interlocutors agreed that export orders were plummeting, a fact that is not yet reflected in official statistics. Zhejiang Financial Affairs Office's Pan made one of

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the most extreme estimates we heard, saying that export orders in the province have fallen by 40% without specifying the time period. Zhejiang Provincial SME Bureau's Gao said that total orders were down 4.9% at this October's Yiwu trade fair of export-oriented consumer goods. Christmas goods orders have been especially impacted, said Jin Chuanshi, Executive Dean of the Zhejiang University's College of Economics.

¶6. (SBU) Shaoxing City was identified by several of our contacts as the epicenter of the impact of the global trade slowdown in Zhejiang. Shaoxing is heavily dependent on textile and apparel exports, said Wenzhou SME Association's Zhou, and also has a higher concentration of foreign-invested firms. When asked where exports have been hit the hardest, Zhejiang Provincial SME Bureau's Gao immediately suggested Shaoxing as an example.

¶7. (SBU) PBOC's Zhou said that Zhejiang's GDP growth in the first nine months was 10.6%, down 4.1 percentage points from the same period last year. Investment growth during the period was around 20%, 4.5 percentage points lower than the previous year, although this number should be further deflated for raw materials cost increases. Export growth was 24.3%, off 4.9 percentage points. Industrial profits growth was down 8.4 percentage points. Government revenue growth was greater than 20%. Zhejiang University's Shi estimated that 10% of the province's enterprises have gone out of business. Among hardest hit in Zhejiang have been auto parts manufacturers and ship builders, due to downturn in demand during the crisis, said PBOC's Zhou.

===== Businesses Responding by Cutting Production and Staff =====

¶8. (SBU) Most Zhejiang businesses have responded first by asking for wage freezes or cuts and then by temporarily closing down production and sending workers home, agreed our interlocutors. Zhejiang SME Bureau's Gao said that SME employers were asking workers to accept lower salaries. Wenzhou SME Association's Zhou and Wang Yibin, Assistant to the President of the Wenzhou Management Science Academy, said that

it was not uncommon for businesses to make under-the-table deals with workers to get around the higher compensation requirements imposed by the new Labor Contract Law. Wang further emphasized that migrant workers from other provinces did not want employers to comply with the law, since under it workers and employers paid into the local retirement system but these accounts are not portable back to the home province.

¶19. (SBU) Zhejiang SME Bureau's Gao said that most enterprises want to continue operations, but at a reduced scale. Workers are being sent home on vacation, with some even being told to stay home until the end of the 2009 Lunar New Year holidays, which will last from late January to early February. This would minimize the impact of the economic growth slowdown on social stability, he offered. Besides, for farmers from Zhejiang it would not be such a bad deal, since they could go back to their villages and draw stipends of RMB20 a day, Gao said.

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Zhejiang's Exporters Losing Confidence in Overseas Markets

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¶10. (SBU) U.S. and other overseas importers are no longer to be trusted, agreed Wenzhou SME Association's Zhou and Wenzhou Management Science Academy's Wang. Zhou said that orders for Wenzhou's major exports such as lighters and eyeglasses are down 30%. In addition, 8%-10% of orders are being cancelled before

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delivery, and it is becoming increasingly more common for exporters not to be paid for goods. "It used to be that you could trust the importers," said Zhou; now, some exporters even refuse to take letters of credit for orders, for fear that the transaction will be caught up in a bank failure.

¶11. (SBU) Zhejiang SME Bureau's Gao said that, according to his contacts among SME managers, U.S. consumers are no longer spending as freely -- "they are learning how to cut costs, just like Chinese consumers," he joked. As an example, he said that one local SME retailed its costume jewelry in the United States through its own outlet. Where once 75% of customers would make purchases in the range of \$100-\$200 per visit, now only 25% of customers made purchases, which average \$50 per visit. Gao said that he had heard U.S. consumers no longer purchase new draperies when moving homes, but instead take their old ones with them.

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Comment

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¶12. (SBU) Our Zhejiang interlocutors were unanimous in assuming that the worst of the economic growth slowdown would pass in the coming seven to eight months, and appeared not to have considered the risk that export growth could continue to slide in the second half of next year. In addition, our contacts were convinced that China's domestic market would continue its strong growth, especially with a boost from the Central Government's high-profile economic stimulus program; none suggested that the additional governmental outlays under the stimulus might be much less than advertised. Zhejiang Provincial SME Bureau's Gao also cited government subsidies -- including subsidies for banks providing funds to SMEs and tax breaks for struggling firms -- as mitigating factors and indicated further government supports could be forthcoming.

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